Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20054

In the Matter of	)	
	)	
Elimination of Rate-of-Return Regulation of Incumbent Local Exchange Carriers	)	RM-10822
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45

Reply Comments of the Ad Hoc Telecommunications Users Committee

The Ad Hoc Telecommunications Users Committee ("Ad Hoc") hereby submits its reply to comments on Western Wireless' Petition for Rulemaking to eliminate rate-of-return regulation of rural local exchange carriers (RLECs).

Ad Hoc commented on Western Wireless' petition because the petition spotlights the astonishing growth in the high cost component of the Universal Service Fund (USF). T-Mobile also pointed out that, "The high-cost USF program has grown exponentially in recent years."[1] T-Mobile states that during the first quarter of 1999 total high cost USF subsidies to all carriers, *i.e*., RLECs and non-RLECs, amounted to $432-million. Five years later, the Universal Service Administrative Company estimates that during the first quarter of 2004 high cost USF subsidies to RLECs alone will be about $720-million. Annualized, RLEC high cost subsidies alone will be nearly $3-Billion.[2] T-Mobile observes that contrary to claims made by RLECs, the growth in high cost subsidies to

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1 T-Mobile USA Comments at 12.

2 *Id*. at 13.

competitive carriers is not the, "[p]rincipal reason the rural USF program is growing so rapidly."[3]

Ad Hoc's comments suggested that the reason for the unexpected growth in high cost USF payments may be one or more of the following reasons: (1) flaws in the *RTF Order,* including use of embedded costs as the basis for determining eligibility for, and the size of, USF subsidies; (2) misallocation of investments and expenses by RLECs, including plant upgrades that may not qualify for USF subsidies; (3) insufficient regulatory oversight of RLEC cost allocations and (4) excessive RLEC earnings and artificially low RLEC rates. While emphasizing that it has not objected to, and is not objecting to, high cost support that is necessary to preserve universal service in high cost areas, Ad Hoc noted that the growth in the absolute support level and the portion of high-cost support that goes to RLECs is disproportionate to any growth in lines or reasonable investment strategies.[4]

A. RLEC Comments Confirm The Need For A Commission Investigation Of The Underlying Causes For The Rapid Growth In High Cost Subsidies.

A few themes run through virtually all of the RLEC comments. They argue that rate-of-return regulation is needed to assure high quality service to rural areas and that the Portability proceeding is considering possible modifications to the cost basis for RLEC USF subsidies.[5] The RLECs assertions about rate-of-return regulation are entirely conclusory and do not undermine the correctness of

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[3] *Id.*

[4] Ad Hoc Comments at 13.

[5] *Federal State Joint Board on Universal Service,* 17 FCC Rcd 22642 (2002) ("the Portability proceeding").

Western Wireless' observations regarding fundamental weaknesses in rate-of-return regulation. The weaknesses are not fatal if regulatory authorities have the resources and the will to enforce rigorously a rate-of-return regulatory scheme. Ad Hoc suspects, however, that as a general matter regulatory authorities lack the resources or the will, and in some cases may lack both. The question then is whether a forward-looking economic cost model would better serve the public interest. The answer is yes. As for the claims that the Portability proceeding will investigate the continued suitability of using embedded costs for high cost USF support determinations, Ad Hoc finds nothing in the order initiating that proceeding that clearly indicates that the Joint Board is to address in the question of whether the Commission should continue to use embedded costs for high cost USF support determinations. That is an inquiry that the Commission has not yet initiated, but should begin very soon.

Some RLECs, however, submitted comments that inadvertently give support to Ad Hoc's call for initiation of a Commission investigation into the reasons for the rapid growth in the high cost component of the USF. In attempting to refute Western Wireless' assertion that rate-of-return regulation eliminates incentives for carriers to introduce innovative technologies and services, TCA, Inc. makes the following statements:

> Despite serving areas with significantly lower customer densities, rural LECs are deploying high-speed Internet access at a far greater rate than LECs operating under price cap regulation. During 2003, approximately three-fourths of rural LECs offered digital subscriber line service ("DSL") to seventy-eight percent of their customers. The successful deployment of broadband in rural, high-cost areas can

> be directly attributed to a regulatory regime, which provides a reasonable opportunity to recover the cost of investing in new technologies. The Rural Task Force ("RTF") confirmed this fact when it found that basing federal universal service support on embedded costs provides carriers serving rural areas increased incentives to invest in new infrastructure and technologies.[6]

Similarly, the South Dakota Telecommunications Association ("SDTA") *et al.* in making the same point about introducing new technology to its subscribers notes that,

> [T]he 2003 NTCA broadband survey reported a full ninety-seven percent of respondents offered broadband service to part of their customer base and plan to deploy fiber to the node to an average of 68 percent of their customers by year-end 2003, fiber to the curb to 7 percent, and fiber to the home to 8 percent. Paul Bunyon Rural Telephone Cooperative has invested over $20,000,000 in the last five years to construct 146 fiber-fed ringed electronic node sites throughout its 3,300 square mile service territory. Not only did this investment greatly enhance the quality and redundancy of the voice network, it allowed the company to offer high speed DSL internet access to over 90% of its subscriber base.[7]

What portion of the plants that RLECs have installed to provide DSL service to their customers has been allocated to the services for which USF subsidies are provided? The foregoing quotes make clear that RLECs have been installing plants to support high-speed internet access service. Costs attributable to high-speed service are not properly included in the cost basis, embedded or otherwise, that is used for calculating eligibility for, and the size of,

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6 TCA Comments at 5-6.

7 SDTA, *et al.* Comments at 7.

USF support, even if the RLECs' costs grow at a rate not higher than allowed by the RTF order and high cost rules. Obviously, the foregoing quotes are not "smoking guns." They alone do not prove that RLECs have engaged in improper cost allocations. However, they should signal the advisability of investigation by the Commission, particularly given the rapid growth in the high cost component of the USF. As explained in Ad Hoc's comments, the Commission should not rely on state regulatory authorities to conduct searching inquiry of such allocations.[8] States do not have the resources to conduct such investigations, and some may not have the incentive to do so.

B. The Oklahoma RTCs Misrepresent The Growth That Has Occurred In The High Cost Fund.

Some RLECs claim, without merit, that the high cost component of the USF really has not grown as much as it appears.[9] The Oklahoma Rural Telephone Companies ("OkRTCs") claim that "the largest cause of growth in the Federal Universal Service Fund is due to disbursements to competitive wireline and wireless carriers, not disbursements to rural ILECs." OkRTCs are, however, dead wrong.

First, the OkRTCs wrongly claim that because "the size of the rural ILEC High Cost Loop fund is limited to the rural growth factor," there is nothing to worry about. Of course, the High Cost Loop (HCL) fund is limited by the rural growth factor.[10] The high cost component of the USF (HCF) has nevertheless increased

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[8] Ad Hoc Comments at 7-8.

[9] Oklahoma RTCs Comments at 5.

[10] Improper cost allocations are still inconsistent with Commission requirements even if the overall loop cost is constrained by the rural growth factor.

dramatically and at an unsustainable rate.[11] The total HCF is comprised of the following major elements:

- High Cost Loop support (HCL);
- Long Term Support (LTS);
- Local Switching Support (LSS);
- Forward Looking Economic Cost Model (FLECM) or High Cost Model (HCM) support; and
- Interstate Access Support (IAS) and Interstate Common Line Support (ICLS).

In 1999 some $1.7-Billion in HCF funds were disbursed to ILECs.[12] Based upon projections for the first two quarters of 2004, HCF disbursements for this year will be $3.6-Billion[13] – more than twice the 1999 disbursement level. Moreover, in 1999 RLECs received $1.5-Billion of the total high cost disbursements. The 2004 projections have them receiving $2.4-Billion – some $900-million *more* than in 1999.[14]

The OkRTCs also argue that "the growth of the Rural ILEC funds is not due to the growth of total ILEC costs, but to the shift in support mechanism from interstate access to the USF." Once again, while it is true that *some* of the growth in the size of the fund has been the result of a shift from interstate access to the USF high cost fund – that shift is not responsible for major potions of the

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[11] As demonstrated in the Joint Board Monitoring report, even with the growth cap, the high cost loop fund increased by 11% in between 2001 and 2002. JBM Report, Table 3.23.

[12] Universal Service Administrative Company (USAC) Quarterly Administrative Filing to the FCC for the 4th Quarter of 1999, Appendix 1: "High cost Fund Support by Study Area."

[13] Universal Service Administrative Company (USAC) Quarterly Administrative Filing to the FCC for the 2nd Quarter of 2004. Appendice file M4 "High Cost Support Mechanism, Fund Size Projections for 2Q 2004." The 2nd Quarter 2004 project high cost program demand is $910.2-million ($3.6-Billion annualized).

[14] Attachment A hereto shows the growth in the various pieces of the high cost component of the USF from 1999 to 2004 (projected).

growth that has occurred in the fund.[15] The OkRTCs point specifically to the Interstate Common Line Support (ICLS) – an HCF component implemented in July 2002 following the Commission's adoption of portions of the Multi-Association Group (MAG) Task Force Plan.[16] During the last quarter of 2002 – the first full quarter for which expenses were projected by USAC – the ICLS fund requirement was projected at $94.4-million (approximately $377-million annualized). Since HCF disbursements to the rural LECs have increased by $900-million since 1999, the OkRTCs' explanation that "explicit transfers" account for the growth in high cost subsidies falls short of the mark. In fact, the fund components initially established as transfer mechanisms from interstate access, have been growing substantially as well – corroborating Western Wireless' analysis. In the year and a half since it was instituted, the ICLS fund has grown by a staggering 20%, with the result that more than $75-million per year *more* in HCF funds are projected to be distributed to rural ILECs for ICLS based upon the most recent 2nd Quarter 2004 estimates, than was projected for the 4th Quarter of 2002.[17]

OkRTCs also point to the LTS and LSS components of the high cost fund as "explicit funds" that shifted interstate access costs into the USF. The LTS

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[15] Additionally, even if the entirety of the increase in fund size was the result of an explicit shift from interstate access services which are regulated via rate of return, into USF, Western Wireless' assessment of the problem and its root cause would not be affected.

[16] *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers, Federal-State Joint Board on Universal Service*, Second Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 00-256, Fifteenth Report and Order, CC Docket No. 96-45, 16 FCC Rcd 19613 (2001) (*MAG Order).*

[17] USAC Quarterly Administrative Filing to the FCC for the 2nd Quarter of 2004. Appendice file HC 11 "ICLS by State" and USAC Quarterly Administrative Filing to the FCC for the 1st Quarter of 2003, Appendice file HC 22 "ICLS by State – revised 4Q 2002."

component was established in 1989, and has grown from an annual disbursement level of $236-million in 1989 to $571-million based upon 2nd Quarter 2004 projections. The LSS component was established in 1993, at which time $311-million in disbursements were made. Current projections for LSS disbursements are an annualized $465-million. In total, the three "explicit" transfer mechanisms identified by OkRTC were responsible for $925-million based upon the first year disbursements for each component. In total, the annual disbursements associated with these three components based upon USAC's most current quarterly projections will be $1.5-Billion.

OkRTCs' final misuse of the USAC data comes in support of its conclusion that it is USF disbursements to CLEC's that are "the largest cause of growth in the Federal Universal Service Fund." OkRTCs cite to Table 3 from a January 2003 OPASTCO report that shows that CLEC disbursements from the federal HCF grew from less than $1-million in 1999 to a projected $106-million for 2003. What OkRTCs do not say, is that the same Table 3 shows the total federal HCF growing from $1.7-Billion in 1999 to a projected $3.3-Billion for 2003, and that of the $1.5-Billion growth in annual high cost fund disbursements from 1999 to 2003, $1.4-Billion (95% of the growth) of the growth in disbursements identified on that table went to ILECs, not CLECs.[18]

In sum, the comments submitted on Western Wireless' petition of rulemaking support, rather than undercut, the need for the Commission (1) to get to the bottom of the rapid and large increase in RLEC USF subsidies, and (2) to

[18] "*Universal Service in Rural America: A Congressional Mandate at Risk*", Stuart Polikoff, OPASTCO Whitepaper published 2003, A-4, Table 3.

initiate a long delayed rigorous look at replacing embedded costs with forward looking economic costs as the basis for RLEC high cost USF subsidies. Existing Commission rules undoubtedly have contributed to the astonishing growth in the USF. These rules have in effect encouraged profligate spending with little or no regulatory oversight, not even the oversight needed to detect possible material cost misallocations. As a steward of the public interest the Commission has a responsibility to take a fresh, hard look at its rules and enforcement mechanisms for the high cost component of the USF.

Respectfully submitted,

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ATTACHMENT A

Growth Has Occurred Throughout the Fund: ICLS and IAS Do Not Explain the Growth

	1999		2004	
	Rural	Non Rural	Rural	Non Rural
High Cost Loop	$ 761,102,064	$ 111,734,040	$ 1,132,529,544	$ 4,059,480
Long Term Support	$ 376,793,616	$ 95,868,636	$ 414,499,728	$ 107,814,456
Local Switching Support	$ 382,272,300	$ 597,768	$ 449,025,312	n/a
High Cost Model	n/a	n/a	$ -	$ 240,877,524
Interstate Common Line Support	n/a	n/a	$ 423,953,592	$ 2,531,568
Interstate Access Support	n/a	n/a	$ 207,132,504	$ 442,845,528
Totals	$ 1,520,167,980	$ 208,200,444	$ 2,627,140,680	$ 798,128,556

Total 1999	$ 1,728,368,424
Total 2004	$ 3,425,269,236
Total Increase	$ 1,696,900,812
Total new Subsidy Components (ICLS and IAS)	$ 1,076,463,192
Total Increase beyond ICLS and IAS	$ 620,437,620

Source: USAC Administrative Filings with the FCC for 4th Q 1999 and 4th Q 2003.